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# In the Supreme Court of the United States

OCTOBER TERM, 1990

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FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

*v.*

ASSOCIATED GAS DISTRIBUTORS, ET AL.

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT*

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## REPLY BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

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## REPLY BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

1. Respondents do not dispute our showing (Pet. 17-18, 27-30) that this case is of surpassing importance to the natural gas industry and to the Commission's effectuation of its regulatory responsibilities. The orders the court of appeals set aside, which prescribe the method by which Tennessee Gas Pipeline may allocate among its customers the costs it incurred in settling its take-or-pay liability to producers, represent a particular application of the general "equitable sharing" policy adopted by the Commission in Order Nos. 500 and 500-H.[1] That policy was instituted to resolve the take-or-pay crisis that has pervaded the natural gas industry since the early 1980s and to spread the resulting cost over the entire industry in a fair and reasonable manner. The Commission's efforts have had a dramatic impact. By the end of 1989, the equitable sharing policy enabled pipelines to reduce their current take-or-pay liabilities by $16 billion and to obtain future relief in the amount of $28 billion. Pipelines paid $8.6 billion to obtain this relief and passed

[1] FERC Stats. & Regs., Regulations Preambles ¶ 30,761 (1987); *id.* ¶ 30,867 (1989).

through $3.4 billion to their customers under the purchase-deficiency method of cost allocation at issue here. See Pet. 11.

By striking down the purchase-deficiency method—and by allowing customers whose past purchasing patterns gave rise to Tennessee's take-or-pay liability to escape responsibility for a fair portion of the settlement costs—the decision below eliminates a central component of the Commission's equitable sharing policy and undermines the overall fairness of that policy. The impact of the decision (involving $3.4 billion in take-or-pay costs) is enormous, and it affects almost all interstate pipelines and their customers. As the Commission explained in Order No. 500-H, all but two of the interstate pipelines with substantial take-or-pay liabilities utilized the purchase-deficiency method to allocate settlement costs among their customers, and the Commission has issued approximately 300 orders on more than 50 proposals by these 22 pipelines. FERC Stats. & Regs., Regulations Preambles ¶ 30,867, at 31,522 & nn.77, 78 (1989). More than 50 petitions for review of such Commission orders are being held in abeyance by the court below pending disposition of this case.

If the decision below is permitted to stand, much of the pass-through that has already been accomplished under these numerous Commission orders will have to be undone. As a result, a final resolution of the take-or-pay problem, and the transition to the competitive market mandated by Congress, will be disrupted and delayed while the Commission conducts still further proceedings in an attempt to devise and implement some other means of allocating take-or-pay costs equitably among pipeline customers. The D.C. Circuit acknowledged in its recent decision in *American Gas Ass'n* v. *FERC*, No. 87-1588 (Aug. 24, 1990), that the ruling below would require the Commission "to unscramble the equitable sharing egg," and it accordingly declined to order the Commission to cease utilizing the purchase-deficiency method while the instant case is before this Court. Slip op. 45.

*American Gas Ass'n* sustained those features of Order No. 500-H that were designed to resolve the take-or-pay problem as between producers and pipelines. Slip op. 25-32. The decision below involves the remaining piece of the puzzle: resolution of the take-or-pay problem as between pipelines and their customers. If the Court grants review and sustains the Commission on that piece as well, it will enable the Commission and the natural gas industry, at last, to put the bedeviling take-or-pay crisis behind them.

Moreover, respondents do not deny that the impact of the D.C. Circuit's novel and expansive view of the filed rate doctrine extends well beyond the take-or-pay context; that court has followed the same approach in invalidating other orders that were similarly designed to allocate costs in a just and reasonable manner. See *Columbia Gas Transmission Corp.* v. *FERC*, 895 F.2d 791, 793-795 (D.C. Cir. 1990), and *Transwestern Pipeline Co.* v. *FERC*, 897 F.2d 570, 576-581 (D.C. Cir. 1990). The Commission has filed certiorari petitions in both those cases, suggesting that the petitions be held and disposed of in light of the Court's disposition of the instant case (*FERC* v. *Columbia Gas Transmission Corp.*, No. 90-131 (filed July 18, 1990), and *FERC* v. *Public Utilities Comm'n of California*, No. 90-367 (filed Aug. 29, 1990)), and the affected pipelines have filed certiorari petitions seeking plenary review (*Panhandle Eastern Pipe Line Co.* v. *Columbia Gas Transmission Corp.*, No. 89-2001 (filed June 22, 1990), and *Transwestern Pipeline Co.* v. *Kansas Power & Light Co.*, No. 90-344 (filed Aug. 24, 1990). Review by the Court in this case can serve to resolve these other cases as well and to forestall a further compounding of the D.C. Circuit's error in future cases.

2. On the merits, we have demonstrated (Pet. 18-27) that the court of appeals' invalidation of the Commission's orders was based not on the terms of the statutory provisions under which they were issued, but rather on a view of the filed rate doctrine as essentially a judi-

cially fashioned rule that can be expanded by the courts in a common-law manner according to the courts' own view of its underlying purposes. The result was to substitute extra-statutory notions for the statutory "just and reasonable" standard as the basis for evaluating the legality of rates that were placed in effect on a prospective basis and designed to permit Tennessee to recover its current costs of settling its take-or-pay liability. Respondents' attempt to defend the court of appeals' invocation of the filed rate doctrine in these circumstances is unavailing.

a. We of course agree with this Court's observations in *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 578 (1981), repeatedly quoted by respondents (Columbia, et. al., Br. in Opp. 13, 15-16, 18) [hereinafter "Br. in Opp."], that Sections 4 and 5 of the Natural Gas Act (NGA), 15 U.S.C. 717c and 717d, "bar[] a regulated seller of natural gas from collecting a rate other than the one filed with the Commission" and "prevent[] the Commission itself from imposing a rate increase for gas already sold." But neither of those things occurred here. Tennessee charged its customers only the rates that were filed with and approved by the Commission for recovering take-or-pay costs. And the Commission did not order Tennessee's customers to pay a higher rate for gas they previously purchased; instead, it approved, on a prospective basis, new filed rates that allocated current costs among Tennessee's current customers, and it did so based on the relative amounts of gas the customers did *not* purchase in a past period. Respondents, like the court below, point to nothing in Section 4 or 5 of the NGA that altogether bars the Commission, in fixing prospective rates, from taking into account the degree to which customers' past purchasing patterns contributed to the current costs those rates are designed to cover. Because Congress therefore has not spoken directly to the issue, the court below was required to defer to the Commission's reasonable interpretation of the NGA as allowing such an allocation. *Chevron U.S.A. Inc.* v. *NRDC, Inc.*,

467 U.S. 837 (1984). Yet the court did not even mention the *Chevron* principle of deference.

Respondents nevertheless seek to justify the court of appeals' invocation of the filed rate doctrine by relying (Br. in Opp. 12 n.18) on the court's conclusion that there is no difference between a charge for gas taken and a charge for gas not taken, and by asserting (Br. in Opp. 19) that the Commission orders therefore retroactively increase the rates paid by Tennessee's customers for gas they purchased in the past. However, the premise of this argument, on which respondents' entire submission rests, cannot be squared with the court of appeals' rejection elsewhere in the decision below of respondents' contention that the assessment of buyout and buydown costs against Tennessee's customers leads to prices for gas they actually purchased that exceed the ceiling price under the Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.* Pet. App. 12a-17a. In rejecting this contention, the court below acknowledged that such payments "are *not* payments for gas to the extent that the gas is not taken." Pet. App. 16a (emphasis added). Other courts of appeals have reached the same conclusion. See *Diamond Shamrock Exploration Co.* v. *Hodel*, 853 F.2d 1159, 1167 (5th Cir. 1988) ("Far from being payments for the purchase of gas, take-or-pay payments are payment for the pipeline-purchaser's *failure* to purchase (take) gas."); *Kaiser-Francis Oil Co.* v. *Producer's Gas Co.*, 870 F.2d 563, 570 (10th Cir. 1989). It follows that the allocation of take-or-pay costs at issue here does not constitute a retroactive increase in the rates paid by Tennessee's customers for gas they purchased in the past.

b. Respondents argue (Br. in Opp. 17-18) that a customer "needs to know the basis on which it is currently being charged for service in order to make its own contracting and purchase decisions" and rate filings, and that the filed rate doctrine bars the Commission from determining that the filed rates "were not high enough" to recover those costs. But this is not a case in which a utility discovered after a filed rate was in effect that

it had omitted certain expenses from its rate filing and the Commission permitted the utility retroactively to alter the filed rate to recover those expenses. As respondents apparently concede (Br. in Opp. 19), the buyout and buydown costs at issue here are *current*, not past costs. The costs were not "known" and "measurable" at the time of Tennessee's earlier rate filings because they had not yet been incurred, and they therefore could not have been included in those filings. 18 C.F.R. 154.63(e)(2).

The dispositive effect that respondents (and the court of appeals) would give to the principle of predictability ignores the "sea change" the natural gas industry has undergone. Pet. App. 141a (Wald, C.J., dissenting from denial of rehearing en banc). It also is divorced from settled applications of the NGA. As respondents concede (Br. in Opp. 12), the Commission often utilizes historical data in setting just and reasonable rates. For example, under Commission regulations, 18 C.F.R. 154.63(e)(2), pipelines select past base periods for fixing new rates, and customers have no way of knowing in advance which past time frame will be selected. During the era of natural gas shortages, the Commission, with the approval of the court below, utilized the same type of base-period benchmark to allocate natural gas supplies in accordance with Sections 4 and 5 of the NGA. *City of Willcox* v. *FPC*, 567 F.2d 394, 408-412 (D.C. Cir. 1977), cert. denied, 434 U.S. 1012 (1978). In light of this precedent, the court below recognized in its recent *Transwestern* decision that pipeline customers historically have not been able to avoid payment of just and reasonable increases in fixed charges attributable to circumstances that were beyond their knowledge when they joined the system.[2]

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[2] The point is illustrated by the hypothetical example of a customer that joined an interstate pipeline system in the 1950s, reasonably expecting to pay only increased direct charges for new pipe, maintenance, etc. However, in the mid-1970s, the pipeline, at a time of gas shortages, decided to construct an expensive liquified natural gas (LNG) facility to receive and regasify LNG from overseas. The pipeline's customers would be required to pay the prudently incurred costs of building the LNG facility through an unavoidable

Expressly repudiating the contrary notion in the decision below, the court stated in *Transwestern* (897 F.2d at 579):

> In so far as prior discussions in our cases have suggested that a rate violates the filed rate doctrine simply because a customer cannot respond in some way that enables it to escape the charge * * *, such remarks were clearly inconsistent with the acknowledged power of the Commission to establish, and to alter prospectively, fixed charges such as demand charges, avoidable if at all only through the elaborate process of securing abandonment under § 7 of the Act.[3]

c. Respondents' reliance (Br. in Opp. 13, 17, 22, 26) on *Maislin Industries, U.S., Inc.* v. *Primary Steel, Inc.*, 110 S. Ct. 2759 (1990), is misplaced. The Commission's actions were fully consistent with *Maislin*'s holding that neither the seller nor the buyer may depart from the published rate known to all parties and that the Interstate Commerce Commission does not have "authority to alter the well-established statutory filed rate requirements." 110 S. Ct. at 2770. In this case, it was the court of appeals, not the Commission, that required Tennessee to depart from the filed rates for recovery of take-or-pay costs, and the court rested that holding on its own view

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direct charge, even though the facility was unanticipated when they joined the system.

[3] Respondents argue (Br. in Opp. 16 & n.23) that the surcharge is impermissibly retroactive because customers that no longer purchase gas from the pipeline may be assessed take-or-pay charges. Under the statutory regime, however, customers whose contracts have expired are still customers of the pipeline until the Commission authorizes abandonment pursuant to Section 7 of the NGA, 15 U.S.C. 717f. Whether or not it is appropriate for the Commission to permit the pipeline to assess take-or-pay liability against departing customers as a condition of abandonment does not implicate the filed rate doctrine. Rather, it requires an inquiry into whether the rate is just and reasonable and whether its assessment is consistent with Section 7 of the NGA. Moreover, this issue is hypothetical in the instant case, because no customer has left the Tennessee system.

of the filed rate doctrine, without reference to the terms of the NGA itself. That approach is at odds with *Maislin*, which makes clear that the doctrine is not a free-floating, judicially fashioned set of principles, but instead is a shorthand reference to the "*statutory* filed rate requirements," 110 S. Ct. at 2770 (emphasis added), and that a court's focus therefore must be on the statutory provisions that "make up the filed rate doctrine," *id.* at 2768. See also *id.* at 2771 (Scalia, J., concurring) (the Court's filed-rate decisions are based "on the text of the statute").

d. Respondents particularly object (Br. in Opp. 20-21) to use of the purchase-deficiency method to allocate costs incurred by Tennessee in payments to producers to reform contracts on a prospective basis, as distinguished from payments to buy out accrued take-or-pay liability. In their view, the customers' purchasing decisions between 1983 and 1986 have no relationship to Tennessee's decision to reform contract terms governing future purchases of gas. This attempt to distinguish between types of costs has nothing to do with whether the purchase-deficiency method of allocating those costs violates the statutory provisions that comprise the filed rate doctrine. As respondents concede (Br. in Opp. 21 n.31), cost causation is one of several factors to be considered in determining whether a particular rate is just and reasonable. But the court below pretermitted all inquiry on that question by concluding that the rates violate the filed rate doctrine. If this Court grants review and reverses that ruling, the case will return to the court of appeals for a determination whether the rates are just and reasonable. Only at that point would respondents' contention be germane.

Respondents' objection is insubstantial in any event. In the first place, the Commission found Tennessee's attempted breakdown of costs between buyout of liability and buydown of contractual terms on a one-third/two-thirds basis to be speculative and unsupported by the record. Pet. App. 90a. The Commission further found that "it would not be necessary to reform the con-

tracts and incur such reformation costs if Tennessee had not experienced purchase deficiencies." *Id.* at 123a. Thus, the catalyst for both the buydown and buyout of take-or-pay costs was the decrease in purchases by certain customers after Tennessee had contracted for new volumes of gas to serve the needs of its customers. Indeed, the D.C. Circuit, in *American Gas Ass'n*, recently endorsed the Commission's conclusion in Order No. 500-H that "the so-called take-or-pay problem arises in reality from 'the combination of high take and high price provisions.'" Slip op. 20. For this reason, a comprehensive resolution of the take-or-pay crisis required settlement of both existing liability and reformation of the contracts that gave rise to it, so that liability would not continue to accrue.[4] Pipelines paid only 18.6 cents on the dollar to settle their take-or-pay problems (current and future), and they passed through 39.3% of that amount to their customers under the purchase-deficiency method. Pipeline customers therefore have not been unfairly burdened with contract reformation costs.

e. Respondents' speculation (Br. in Opp. 23-26) that there are other readily available solutions to the take-or-pay pass-through problem is without merit. The notion (Br. in Opp. 24-25) that pipelines could recover these monies through their commodity charges is incorrect. The Commission afforded each pipeline the opportunity

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[4] Respondents err in relying (Process Gas Consumers Group, et al., Br. in Opp. 9-10) on the circumstances of the City of Andersonville, Georgia, which is a customer of another pipeline involved in a separate proceeding and which allegedly decreased its purchases during the deficiency period because a major purchaser of its gas switched to alternative fuels. Under Section 502(c) of the Natural Gas Policy Act of 1978, 15 U.S.C. 3412(c), the Commission may grant exemptions from its rate orders on the ground of hardship. The Commission tentatively approved such a hardship exemption for the City of Andersonville, subject to the subsequent submission of data to document the claim. *South Georgia Natural Gas Co.*, 47 F.E.R.C. ¶ 61,420 (June 21, 1989). The Commission's response to the City of Andersonville's situation thus demonstrates the basic fairness and reasonableness of the Commission's overall approach.

to recover 100% of its buyout and buydown costs in that manner but none attempted to do so, since their customers could avoid payment by decreasing or ceasing their purchases.[5] Instead, the pipelines agreed to absorb up to 50% of their costs in order to have a realistic opportunity to recover an equivalent amount through the purchase-deficiency method. The suggestion (Br. in Opp. 26) that the Commission impose either a direct charge allocated in accordance with a customer's current contract entitlement or a "volumetric" surcharge on future rates for both sales and transportation of gas is, at best, problematic. Respondents concede (Br. in Opp. 21 n.21) that an important component of the "just and reasonable" standard is that rate allocation should match as closely as possible the cost of providing service, and these methods would depart substantially from that central regulatory principle. See Pet. 28-29.

For the foregoing reasons, and those stated in the petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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[5] In *Associated Gas Distributors* v. *FERC*, 824 F.2d 981, 1026 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988), the court below itself recognized that a normal commodity rate recovery was infeasible since only those pipeline customers that were "exceptionally sclerotic about purchasing gas from brokers or producers" would remain on the pipeline system and still pay these additional costs.

* The Solicitor General is disqualified in this case.

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